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CONSPIRACY TO RAID THE REVENUE AUTHORITY WITH SPECIAL EMPHASIS ON TAX AVOIDANCE UNDER THE SOUTH AFRICAN LEGAL REGIME

A Thesis presented to

The Faculty of Law

University of Cape Town

In partial fulfilment of the requirements of the Master of Laws Degree

by

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October 1998

"Research dissertation presented for the approval of Senate in fulfilment of part of the requirements for the degree of Master of Laws in approved courses and a minor dissertation. The other part of the requirement for this degree was the completion of a programme of courses"

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CHAPTER ONE

INTRODUCTION

"[I]f a taxpayer, acting on ingenious advice succeeds in avoiding the payment of tax which other taxpayers, who do not have access to such ingenious advice, pay ... and in the result *Fiscus* loses tax, it is not customary for the courts to shed any tears on behalf of it; the taxpayer has done what he was entitled to do, and that is the end of the matter. What is sauce for the goose is sauce for the gander"[1]. (Emphasis Mine)

"If the person sought to be taxed comes within the letter of the letter of the law he must be taxed however hard the hardship may appear to the judicial mind to be. On the other hand if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, [he] is free however apparently within the law the case might appear to be"[2]. (Emphasis mine)

In any tax planning strategy, the best option is to receive an amount [that] does not attract any tax at all[3].

"[H]onesty in regard to tax matters is often something different and ... less than the rest of our lives[4]."

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[1] Greenfield J, President of the Income Tax Appeals Special Court In *G v. Commissioner of Taxes* 1971 (4) S.A 274

[2] Lord Cairns' famous dicta in *Partington v. The A-G* L.T. 370 at 375. It was cited with approval in *CIR v. George Forest Timber* 1924 A.D. 516 at pp 531-2

[3] Delloitte Haskins and Sells *Tax Service* Issue No. 2 February 1990 1

[4] ibid at 221C

1.1: IMPORTANCE OF TAXATION TO A COUNTRY

Two things have been said to be certain in life: taxes and death. It is trite knowledge that in many countries of the world today, citizens contribute to the State coffers in the form of taxation. The collected taxes[5] are intended to finance the State's expenditure. This is in the field of health, housing, water, education and infrustructural facilities, as well as maintenance of public services, for instance, the police force. An almost direct relationship exists between taxes and the provision of these services. Where taxpayers fail to honour their dues, as and when they fall, then these services will suffer similarly. Finally a collapse of the provision of these vital services is an undesirable end no country strives to achieve. Legal rules have thus been laid down to ensure collection of the maximum tax.

Under the supreme law of the land in South Africa, the Constitution, general power of taxation of citizens is not expressly provided for. However this power can be inferred from the general grant of legislative and executive authority in sections 37 and 75 read together with section 156 of the Constitution. These provisions divide the taxing power into three categories: National; Provincial, to levy a limited range of taxes falling under the provinces; and a mixture of the two operating at the provincial level. Further sections 60 and 156 place procedural restraints on the exercise of these powers, while certain provisions in Chapter 9 and 12 regulate distribution of revenue in the interests of equitable fiscal equalisation and circumscribe the taxation of national economic activities and inter-provincial commerce[6]. The procedural part of the Constitutional inferred power is contained in the Income Tax Act[7], ITA, which regulates, *inter alia*, the "recovery of taxes from persons ..."[8]. The Commissioner for Inland Revenue is charged with the task of collecting income tax, and all other taxes imposed by the Income Tax Act. Thereunder all eligible tax payers are expected to contribute into the State coffers.

[5] These could be in the form of sales or income tax.
[6] For a complete excusus on the constutionality of taxation see Murphy J *The Constitutional Review of Taxation* Acta Juridica 1995 89. These were his observations at p 90.
[7] No 58 of 1962 as amended up and including Act 28 of 1997
[8] See Preamble to the Act. Word "Person", in legal terms, is normally defined to include companies and individuals. In South Africa, under section 1 of the ITA, it "ncludes an insolvent estate, the estate of a deceased and any trust".

Statistically an expected one hundred, 100, million was expected to be collected in the 1995/96 year of income, according to the then Minister of Finance in his 1995 Budget Speech. However this target was not achieved. One of the reasons thereof could be tax avoidance and evasion. The distinction between tax avoidance and evasion, which although trite, is worth mentioning. Tax avoidance involves arranging one's affairs legally to pay less tax. Evasion on the other hand involves dishonesty, for instance falsification of accounts or returns and non-disclosure to the tax Authorities[9]. Avoidance is legal while evasion is nothing more than cheating.

1.2: THE CONCEPT OF TAX AVOIDANCE IN SOUTH AFRICAN

Over time the Government of South Africa realised that not all were willing to bear this tax burden partially or at all. Such persons, often referred to as 'tax dodgers', being ingenious and with the aid of tax advisors, always come up with ways to circumvent the law and hence avoid being hit by the taxing statute. Alternatively their liability is minimised, as far as is legally and commercially possible. Today this practice is broadly referred to as 'Tax Planning'. Skill in the planning lies in effecting the reduction with a minimum of cost and disruption to the conduct of the taxpayer's affairs[10]. Such schemes involve fixed property acquisitions, convertible debenture issues, intellectual property and leasebacks, increase in deductions, elimination of prospective receipt of income and reduction of tax rates or deferral of payment[11]. Their general effect is to legally diminish their tax liability.

It is trite law that, a person is not obliged to pay the maximum tax, as long as he can organise his affairs well enough and get round the fenceposts as set by the ITA

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[9] see Meyrowitz D *Meyrowitz on Income Tax* (1995-96) par 29.1; de Koker A *Silke on South African Income Tax* Memorial Ed (1989) vol. III par 19.1; and the Minister of Finance 1995 Budget Speech.

[10] Delloitte Haskins and Sells op cit Note 3 p1

[11] See also Delloitte Haskins and Sells op cit Note 3 p 1

Lord Clyde pointed out, that in Britain, “no man ... is under the slightest obligation ... to arrange his legal relations to his business or his property as to enable .... Revenue put the largest possible shovel into their stores”[12]. The South African Commissioner of Inland Revenue expressed similar sentiments as recently as 1987[13], while the Minister of Finance referred to such schemes as “legal”. Thus a taxpayer who arranges his affairs so as to minimise his tax liability in a manner which does not involve fraud, dishonesty, misrepresentation or other actions designed to mislead the Commissioner complies with his duties and obligations under the Act. This is further achieved as long as they honestly and fully complete their tax return and answer any queries raised by the commissioner. Courts have also come in to strengthen this position. They have posited that taxpayers are not obliged to pay a maximum tax than is legally due under the Statute. Entering into transactions, schemes or operations to avoid or reduce their liability to tax, is permitted on condition that they do not contravene any provision(s) of the relevant tax statute[14]. Concern is normally for the illegal schemes mooted to avoid payment of tax. The Minister described this practice as being, “unacceptable”.

Another category of acceptable schemes is also worth mentioning. These include absentation from earning income by closing down ones business; earning less income by selling investments producing income subject to tax and either not reinvesting proceeds therefrom or buying a capital asset not producing any income or producing income not subject to tax in their hands; selling shares in companies which pay high dividends and investing in securities which return a lower but safer and more certain income; by reducing ones fees, for a professional; or selling at a loss. These are not the type of “unacceptable” schemes envisaged by the Minister. As Watermeyer CJ, in *CIR v. King*[15] put it succinctly:

> “it cannot be imagined that Parliament intended .... to do such an absurd thing as to levy a tax upon [such] persons....”

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[12] In *Ayshire Pullman Motor Services v. IRC* 14 TC 754 at 764

[13] See Practice Note 6 Issued on 1 April 1987 at 640

[14] See Viscount Sumner in *Levene v. IRC* (1928) AC 217 ; Lord President Clyde in *Ayrshire Pullman Motor Services and DM Ritchie v. IRC* 14 TC 754 at 763-4; Lord Tomlin in *Duke of Westminister v. IRC* 19 TC 490 at 520; Centrelivres J in *CIR v. Estate Kohler* 1953 (2) SA 584 (A); *SIR v. Hartzenburg* 1966 (1) SA 405 (A) at 408; and *Hicklin v. CIR* 1980 (1) SA 481 (A);

[15] 1947 (2) SA 196 (AD) at 208

The Legislature's intention was to ensnare only unacceptable practitioners into the tax bracket.

It is rather noteworthy that the taxpayer and Revenue relationship appear akin that of a hunter and hunted scenario. Revenue in seeking to collect the maximum will pursue the taxpayer at all costs. While the taxpayer, in retaliation, will try and be innovative and aggressive in planning all in a bid to 'escape' from Revenue's net. Either party, in this process, will not fail to utilise the slightest advantage they can get over the other. One commentator, while describing this relationship in practical terms observed:

> "[I]t is necessary for both the tax gatherer and tax payer to recognise that they <u>stand in an inherently adversarial relationship to one another</u>. [T]he former wishing to gather as much tax as possible and ... latter, ... pay as little as is legitimately possible"[16]. (Emphasis mine)

One of the arguments advanced by tax-dodgers, at a practical level and in a picturesque manner, while advancing the hunter-hunted scenario, is:

> "... Revenue is not slow-and quite rightly - to take any advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in the like manner, entitled to be astute to prevent so far as he can, the depletion of his means ...[17]"

This relationship was been described as "... an intellectual game of chess between the Revenue and the taxpayer's advisors"[18] and which later on developed into a "full-scale war"[19].

Tax Avoidance ... presupposes some legal arrangement or transaction which, but for some special provision contained in the Act, would not render the taxpayer liable for tax[20]. The Minister of Finance in his opening speech in the debate on the second reading of the Income Tax Bill in 1980, described tax avoidance as, "efforts

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[16] The Taxpayer Vol 45 No. 10 October 1996 at 183

[17] Lord Clyde in *Ayshire Pullman Motor Services v. IRC* 14 TC 754 at 763-4.

[18] See *The Taxpayer* September 1988 164

[19] See the *Income Tax Reporter* 28 (1989)71

[20] Meyerowitz D and Spiro E, *Meyerowitz and Spiro on Income Tax*, Cape Town: Pioneer Press (1995) para 773.

within the law to minimise tax repayments", through "rearranging ... one's affairs in an artificial manner ... for [the sole or main] reason [of] only of avoiding tax". This practice arises where a [person] for the purpose of tax saving so orders his affairs that he escapes from a liability for taxation on income [that] is in reality his[21]. According to Shreiner JA, ones "income" referred to the product of the capital, labour or both.

The economical objection to tax avoidance is that it causes sterility and harm to the national economy. If allowed to persist then the R 100 million approximated by the Minister in the 1995/96 year of income would never have materialised. The practice makes no contribution to the Gross National Product; the fabrication of [such schemes] is a waste of creative intellectual talent; and the result .. often to channel investment to tax efficient rather than economically rational destinations ...[22].

Anti-avoidance rules and regulations thus developed in retaliation to the avoidance schemes. As the dodgers hatched more schemes, so did Parliament give chase in an effort to plug these loopholes. This plan proved highly unsuccessful leading to the shift and adoption of a general anti-avoidance provision. In the words of the Minister, in his 1995 Budget Speech, "the Government [was] taking a hard line against the erosion and misuse of the tax system by various tax avoidance schemes". Today taxes imposed by the ITA are normal, donations, non-residence, shareholders secondary tax on companies, levy on financial institutions and income tax. This general anti-avoidance provision is in section 103 of the Act, divided into 7 subsections. Schreiner J. A[23], while commenting on the purpose of section 90, the equivalent of section 103, of the former Act, said vis-à-vis what Revenue seeks to tax:

> "Now normally and naturally the owner of an income-producing asset receives the income and the labourer ... rewards for his labour. Any departure from this order of things, if done with the object of prejudicing the *fiscus*, is the subject of legitimate objection by the Commissioner, which is met by the machinery of the section. In such cases .... it can be said that [h]e is seeking to tax the taxpayer on what is 'in reality his income'.... It is in reality his income because it should have accrued to him, and it can only be said that it should have accrued to him if it was the fruit of his labour or both" (Emphasis Mine).

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[21] In *CIR v. King*[21] 1947 (2) SA 196 (AD)

[22] Williams RC *Income Tax in south Africa: Law and Practice*, Durban: Butterworths, (1996) 656-57

[23] In *CIR V King* 1947 (2) SA 196 (AD) at 215

Section 103 does not impose a tax nor does it relate to the tax imposed by the Act ... liability or incidence therefor but rather to schemes designed for the avoidance of liability thereof[24].Upon enactment initially, the section was intended to frustrate avoidance schemes involving use by South African taxpayers of foreign companies[25].

Apart from this general provision there is a range of other specific provisions namely sections 7 (3) and (4) which deems any income which accrues to a minor child as a result of a disposition by the parent to be income of the parent, while (5), (6) and (7) therefore designed to hit at means of disposition wholly or partly gratuitous by deeming the income accruing to or accumulated for the donee to be that of the donor; 8B to D , aimed specifically at dividend-stripping operations; 8(5), prevents use of previously deducted rentals to pay for the acquisition of the assets; and 31, dealing with transfer pricing.

The backbone of the thesis will be section 103 whistle bearing in mind the words of Lord Greene, MR, in *Lord Howard de Walden v. IRC*[26]:

> "For years the battle of manoeuvre has been waged between the Legislature and those who are minded to throw the burden of taxation off their shoulders on to those of their fellow subjects. <u>In that battle the Legislature has often been worsted by the skill, determination and resourcefulness of it's opponents .....</u> It scarcely lies on mouth of the taxpayer who plays with fire to complain when he gets his fingers burnt.

My examination will now proceed to examine the skill, determination and resourcefulness of the taxpayers in avoiding tax. Revenue's attitude towards the same and it's success, or otherwise in bringing taxpayers under the ambit of the statute. The thesis will take the following deportment. I will commence with an analysis of transactions, schemes or operations entered into by persons solely or mainly to obtain a tax benefit. Thereafter I will examine in Chapter III the concept of assessed losses and

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24 Botha JA in *Glen Anil Development Corp. V. CIR* 175 (4) SA 715 at 727

25 This infomation is contained in the, then, House of Lords Debates of 22-27 June 1959 Col 8821 as quoted in Silke at 19-5.

26 (1942) 1 KB 389 at 397

how corporate taxpayers have sought to utilise the same as a means of avoiding tax. The study will also examine how the commissioner has reacted to these and sought to bring the prospective taxpayers under the ambit of the Statute. In both instances attention will be paid to how the judges have sought to interpret the law, as well as other tax commentators, as contained in the ITA. Finally I will make some Closing remarks.

CHAPTER TWO

AN EXCURSUS THROUGH THE GENERAL ANTI-AVOIDANCE PROVISION OF THE INCOME TAX ACT, SECTION 103

2.1: INTRODUCTION

As discussed in Chapter 1, Section 103 of the ITA was enacted to curb tax avoidance schemes by 'tax dodgers'. Avoidance of liability for payment of tax ordinarily means escaping or preventing an anticipated liability[27]. In this Chapter I will analyse firstly, transactions entered into or carried out to reduce or avoid the payment income tax. Thereunder I will examine the normality tests as set by the Act and the concept of arms length and the rights and obligations arising from such transactions. I will conclude with a discussion of the powers of the Commissioner in treating such schemes.

2.2: SECTION 103 (1) OF THE INCOME TAX ACT

For the Commissioner to have *locus standi* to invoke section 103(1) of the ITA he must be satisfied that a transaction, operation or scheme:

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[27] See *Smith v. CIR* (1964) 1 SA 324 (A)

(a) has been entered into or carried out [and] which has the effect of avoiding or postponing liability for the payment of ... tax ... or reducing the amount thereof; and

(b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out

(i) was entered into or carried out [in the case of]:
(aa) a [business] transaction[28] ... in a manner which would not normally be employed for *bona fide* ... purposes, other than obtaining of a tax benefit; and
(bb) any other transaction or scheme not falling within the provisions of item (aa), by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction of [that] nature ;or

(ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction of [that] nature; and

(c) was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit.

In other words the following prerequisites must be established before the commissioner can purport to invoke section 103(1):

- A transaction, operation or scheme should be entered into or carried out by a taxpayer with the effect of avoiding anticipated[29] liability for income tax; and
- the prevailing circumstances should rule out the normality tests set in subsection (b) (i) and (ii) above; and
- avoidance of tax liability being should be the sole or one of the main purposes of such a scheme.

From the direct quotation of section 103 (1), above, use of the word "and" to link the subsections infers the Legislature's intention for the fulfilment of all three requirements, before the commissioner can seek to invoke the section. This proposition

[28] This should be construed as including "operation or scheme".
[29] The Act refers simply to "liability", whistle the Legislature's intention was interpreted as "anticipated" see *Smith v. CIR* 1964 (1) SA 324 (A) at 333E-G and *Hicklin v. SIR* 1980 (1) SA481(A) at 492F-H.

has been judicially recognised[30]. The subsection pre-empts an anticipated liability of tax, sought to be avoided by a taxpayer. In addition there is a presupposition of a pre-existing stream of income, either proximate or remote, without which no liability can accrue. In some instances it may be difficult to establish whether one is dealing with a new or pre-existing source. Clegg gives a picturesque view of the situation and observes:

> "If the scheme consists of the diversion of a stream below the dam, then there is a pre-existing source. If the sluice gates are closed and a new stream is started from sluice gates at another point of the wall, there is no pre-existing source".

In this analogy a person's capital or ability to labour is the "dam", while the "sluice gate" refers to the manner of investment or the style of his labour. Only upon satisfaction that no new source has been created, that is no " new stream is started from the sluice gates", by a scheme, will one take the inquiry further to determine whether the other requirements of the subsection, have been fulfilled.

Once all the tests have been satisfied the commissioner is empowered, under subsection 1(c), to determine tax liability in a manner he deems appropriate. This does not grant him a *carte blanche*. Regard must be had to the spirit and letter of the Act. The powers are limited to seeking to prevent or diminish the intended avoidance or postponement of liability for the payment of any tax duty or levy imposed by the ITA or any other law administered by the Commissioner or reduction of the amount thereof. Alternatively the commissioner may disregard the transaction and determine the income tax liability as it had not been entered into to. These powers will be discussed fully in part 2.2.4.

This discussion will shift to examine the three tests laid by section 103(1) that the commissioner must fulfil before attempting to invoke part (c) thereof against taxpayers. In addition how Courts have reacted to these attempts.

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[30] See Corbett J in *SIR v. Geustyn, Forsyth and Jourbet* (1971) 3 SA 567 (A) at 571E-H who opined that, under subsection (1) all the elements must be satisfied before the Commisssioner can purport to invoke the section. See also Botha JA in *Glen Anil Development Corp* 1975 (4) SA 715 on interpretation of sec. 103 at 727h; *SIR v Geustyn, Forsyth and Jourbet* 1971 (3) SA 567 (A) at 571E; *SIR v Gallagher* 1978 (2) SA 463 (A) at 471B-E; Corbett JA in *Louw v CIR* 1983 (3) SA 551 (D); and Trollip JA in *Hicklin v SIR* 1980 (1) SA 481 (A).

2.2.1: TRANSACTIONS, OPERATIONS OR SCHEMES ENTERED INTO OR CARRIED OUT BY A TAXPAYER WITH THE EFFECT OF AVOIDING OR POSTPONING INCOME TAX LIABILITY

The commissioner must be satisfied that the transaction(s), operation(s) or scheme(s), in question, has been entered into or carried out by a taxpayer, and has the effect of avoiding or postponing income tax liability. This constitutes the first hurdle for the commissioner as posited by subsection (1) (a) of the ITA. The generality of the subsection makes it almost impossible for any person to escape from its ambit. It is widely worded by referring to "transactions, operations or schemes". It is quite difficult to envisage a business venture or otherwise not likely to fall under this general classification. Maybe this explains why this requirement does not usually form the subject matter of legal battles between taxpayers and the commissioner. Hence not so much litigation has arisen from this area.

A series of transactions, however, has been held by courts to constitute a scheme even though not all the steps were contemplated at the onset despite the fact that the intention to avoid the payment of tax appears only in the latter steps. As a prerequisite courts have said that there must be unity between the steps before a scheme can be regarded as commencing, only then will the ultimate result be decided upon[31]. The most obvious mode of postponing liability is to postpone the accrual of or receipt of income. In the case of *Louw v CIR*[32] the court found that the effect of the transaction was bound to avoid or postpone liability for income tax or reduce the amount thereof. Sale of the partnership practice to the company resulted in a postponement of tax liability. A portion of the firm's income because of incorporation would no longer accrue hence be taxable on the respondent's hands. Liability as envisaged here is a future or anticipated liability. It would be impracticable to avoid or

[31] see *Hicklin's* case where Trolip J found that the only transaction, operation or scheme was "the [sale]" agreement, and also *Louw*.
[32] See full facts at p 22

postpone a current or worst still past liability. Indeed if this was the case section 103(1)(a) would seemingly be deprived of its practical effect. This view is also shared by the courts. Trollip J in *Hicklin v SIR*[33] opined that:

> "Liability" in s103(1) does not refer to an accruing or existing one, for such [cannot] be avoided by any transaction etc."

While in the words of Steyn CJ in *Smith v. CIR* [34]:

> "The ordinary and natural meaning of avoiding liability for a tax on income is to get out of the way of, <u>escape or prevent an anticipated liability</u>"[35]. (Emphasis mine)

It would be quite difficult to draw a vertical line delimiting the connotation of "an anticipated liability". The court in *Hickin's* case[36] while recognising this fact found that the second requirement, anticipated liability, was fulfilled. This is because, "the liability of appellant ... to tax on Reklame's distributable profits, albeit a liability contingent upon them declaring as dividends, was clearly anticipated"[37] within the contemplation of s 103(1). The shareholders in this case were always mindful that something unforeseen might occur hence compelling them to declare those profits as dividends and as a result incur the ensuing tax liability.

2.2.2: THE ABNORMALITY TESTS

Where the commissioner succeeds in establishing that a transaction, operation or scheme was entered into or carried out and which had the effect of avoiding or postponing income tax liability, the next inquiry is two pronged. First inquire into the mode of entering into or carrying out a transaction. And secondly whether the rights

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33 1980 (1) SA481(A)

34 1964 (1) SA 324 at 333E-G

35 See also *Newton and Others v.Commissioner of Taxation of the Commonwealth* (1958) 2 All ER 759 (PC) at 753F-G. Lord Denning seems to concur with this proposition. He opines that this means liability for tax that the taxpayer anticipates will or may fall on him in the future.

36 See full facts at p 24

37 at 493A-B

and obligations created are normal between persons transacting at an arms length level. The first inquiry can further be divided into two, business and non-business transactions. I will commence with transactions under the first prong.

2.2.2.1: BUSINESS AND OTHER TRANSACTIONS

The mode of entering into or carrying out a transaction is further classified into business and Non-business transactions. Business transactions will constitute the subject matter of my first discussion.

2.2.2.1.1: BUSINESS PURPOSE TEST

The ITA requires of the commissioner to have regard to the circumstances under which the transaction was entered into or carried out it, for a [business] transaction. This should be in a manner that would normally be employed for *bona fide* purposes, rather than to obtain a tax benefit. This is the normality test as enshrined in subsection (1) (b) (aa) of the Act, and worded in a negative manner. It was enacted following recommendations by both the Margo and Katz Commissions. Both Commissions expressed difficulties encountered in applying the abnormality test. According to the Margo Commission, if a certain type of transaction was to be widely used for tax avoidance purposes, then it would later become commercially acceptable and hence normal[38]. The Katz Commission[39] also pointed out this danger, and added the ambiguity as to weather the abnormality test remained an objective test "despite the context of specific circumstances"[40]. Furthermore, taxpayers who entered into an avoidance scheme, even if it is successfully challenged by the Commissioner, often suffered minimal downside as interest was not automatically imposed for underpayment of tax[41]. However today where the Commissioner has invoked the anti-

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[38] See *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* (RP 34/1987) par 27.28

[39] See *The Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of of South Africa* par 11.2.2

[40] At par 11.2.3

[41] See Delloitte and Touche *Tax News* June /July 1996 Issue No. 4/96 p 8

avoidance provisions against a taxpayer, he is precluded from waiving any interest chargeable, in instances of underpaid tax, for that portion of tax hit by section 103.

No universal test for normality, for business transactions, can be drawn. Though the "manner which would *normally* be employed" implies an objective test (emphasis mine)[42]. A prime factor under subsection (b)(ii), and discussed at part 2.2.2.2, is weather the parties are independent persons and or have conducted their dealings at an arms length. This category includes transactions which though not commercially 'abnormal' *per se,* but in their means or manner would not have been entered into but for the tax benefit accruing therefrom. A "tax benefit" is defined, in the definition section of the ITA, to include any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed under the Act or any law administered by the Commissioner. The other laws include The Estate Duty Act No. 45 of 1995, Value Added Tax Act No. 89 of 1991, Transfer Duty Act No. 40 of 1949, Stamp Duty Act No. 77 of 1968, and Marketable Securities Act No. 32 of 1948. Thus a business transaction will be abnormal either if, one, it was concluded or executed in manner not normally employed for *bona fide* business purposes. In the alternative if it has created abnormal rights or obligations. It would also be worth noting the circumstances under which the transaction was entered into and it's nature.

arm's length

Problems have arisen in interpreting this amending provision. Reference is made to "the context of business". However the ITA fails to define the word 'business'. One would therefore be correct to assume it bears an ordinary meaning. The Act, does, however, contain a very wide definition of the analogous concept "trade". This raises the question why "business" is used in section 103 rather than the more familiar term "trade"[43]. Trade, as defined, includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent, design, trade mark, copy right or similar property. Would it not have been wise for the Legislature to use this wider "trade" definition with specific inclusions, as opposed to the

[42] This view is shared by Williams who opines that' "words, 'in a manner that would not normally be employed for *bona fide* business purposes, other than obtaining a tax benefit' appear to postulate a wholly objective test. Williams RC *The 1996 Amendments to the General anti Tax-Aviodance Section of the Income Tax Act* SALJ 1997 114:4 667

[43] Linde KVD *Tax Avoidance: The New Abormality Requirement in Section 103 (1) of the Income Tax Act* (1997) 9 SA Merc LJ 54 at 57

"business" definition? Suffice it to note that the Katz Commission had, at par 11.5.5, 11.5.6, and 11.5.8 of its *Third Interim Report*, recommended use of the word "trade". Practically this distinction is bound to affect a number of cases.

Once it is established that a transaction took place in the context of a business, the question that follows is, whether it was entered into or carried out in a manner which would not normally be employed for *bona fide* business purposes other than obtaining a tax benefit. In the words of Linde, a tax commentator, "it is not required that the business purpose must be dominant, but only that such transactions should normally have some business purpose"[44]. While Steyn CJ in *Smith v. SIR*[45] said of subsection (1) (aa), of the ITA, *inter alia* item (i):

> "If the means and manner are those normally employed in the entering into or carrying out a transaction .... of the same nature, and if the rights and obligations created are those which would normally be created under such a transaction ...., between persons dealing at arms' length, the section would not apply, even if, of set purpose, a liability for income tax is being avoided or postponed or the amount thereof reduced. In terms of the section, the abnormality of means, manner, rights or obligations, is a matter for the opinion of the Commissioner, but in terms of subsection. (2) his decision is subject to objection and appeal".

The judge appears to suggest an objective test to the inquiry. Thus as long as a majority of business practitioners use the same transaction(s) for business purposes, it is okay, being the norm "not abnormal". Upon a bare reading of the subsection this is a reasonable conclusion to be arrived at. Will a taxpayer under attack therefore not be likely to walk out of the ambit of section 103, even if his sole or main purpose was tax avoidance?

The words "*bona fide*", in my opinion, do not add much meaning to the 'business purpose', save stress that this purpose should be real. The section further fails to specify whether the transaction should normally involve business for both

44 Linde KVD ibid at p58

45 at p 332E-H

parties, or whether the party in the position of the taxpayer should normally conclude such a transaction for business purposes[46].

The case of *Hicklin v SIR*[47] is one worth mentioning in this regard to see how the courts have dealt with this test. Directors' loans, seen in the context of the amount allocated by way of salary and dividends, were found abnormal thus held to have failed the normality test. Account[48] was taken by court of the following factors: (i) "liquid reserves" partly created by the relatively small annual amounts allocated by the directors through salary and dividend, were not kept in the coffers of the company, but advanced to the directors as interest-free, unsecured loans; (ii) magnitude of the loans, for instance in 1974 respondent's loan of R106 480 was more than double his combined salary and dividend pay-out of R43 466; (iii) salary and dividend received by a director being sufficient to cover his living costs, the surplus income which he would otherwise and in the normal course have received and invested came to him in the form of a loan; and (iv) the loans were not made in specific amounts under specific authority, but were merely amounts arrived at each year by deducting from the total of drawings and disbursements of the year the salary and dividend due to the director; and it appeared to be unlikely that the loans would ever be called up or intended to be.

2.2.2.1.2: OTHER TRANSACTIONS

For any other transactions or schemes not falling within the ambit of business, subsection **2.2.2.2.1** above, the commissioner's consideration is weather the means or manner which were employed were those which would not normally be employed in the entering into or carrying out of a transaction of [that] nature. The abnormality test is the second limb of the first inquiry, that is mode of entering into or carrying out a transaction, and is contained in subsection (1) (b) (bb) of the ITA. This test distinguishes between 'acceptable' and 'unacceptable' tax avoidance. The measure of normality or otherwise of a transaction appears to be wholly an objective inquiry. The test is that of a reasonable person, hence the transaction has to be conducted at an

[46] Linde KVD op cit Note 44 p58
[47] 1980 (1) SA 481 (A)
[48] see ibid at 581C for the specific words

"arm's length". This principal, arms length, does not find its way in the business purpose test since this, presupposedly, forms the basis upon which such transactions are based. This category involves transactions which were originally entered into for *bona fide* business purposes, but which were thereafter restructured, the taxpayer entered into a new, amended transaction,[49] for no apparent honest business purpose save obtainment of a tax benefit not available under the original structure.

Importance of this test should not be under estimated. Take a taxpayer who enters into a tax avoidance transaction and ensures that it is concluded as per the normal business practice "rules" and "regulations". He can still come under attack if the rights and obligations are established not to be normal. Would it be wrong to conclude that the Act contemplated the application of the alternative abnormality tests in section 103 (1)(i)(bb)? Both tests can be used to evaluate the normality or otherwise of a transaction. However it is important to distinguish between the manner and effect or result of a transaction in a business context courtesy of the different tests applicable.

The phrase "manner normally employed" read together with the word "circumstance" in subsection (1)(b) in part 2.2.2 above encompasses a situation whereby there is a financial transaction already in place. Courts are given a discretion in determining the relevant "circumstances". Does this not introduce an element of subjectivity into the entire test? No two situations can purport to have similar relevant circumstances. The bridging word between the provision governing businesses and this abnormality test is "and", while between the two normality tests it's "or". The result of this is rather interesting. Either test gives the Commissioner *locus standi* to proceed with the tax avoidance inquiry. Courts, on their part, seem to have been inclined to treat the two tests as a single one and simply ask weather or not the transaction is normal[50]. The test for abnormality from the above is two fold, one consider the circumstances and secondly nature of the transaction.

Simulated or disguised transactions have also come to the fore. These are those wherein the parties in order to secure some advantage or avoid some disability, conceal the true character of the agreement. According to de Koker[51],:

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49 Williams RC op cit Note 42 p 678

50 See ITC 963 24 SATC 705

51 At para 19-29

> " [I]f a holder ... transfers assets to a company that cannot pay ... for them, he would be inviting the application of section 103(1) if he sells them at values between their current market prices or ... leaves the purchase price as an interest free loan , these being rights or obligations that would be normally created by persons dealing at arm's length.

And proceeded to add:

> "[G]ifts or donations of assets by one person to another in order to avoid tax are not hit by [the section, provided that [they are] not effected in the customary form and [do] not create any abnormal rights or obligations".

I will now turn to examine how have courts interpreted this test. In *Louw v Commissioner for Inland Revenue.*[52] The taxpayer was a member of a partnership of consulting engineers which in 1966 decided to incorporate their practice. This meant transfer of the practice business to a company with unlimited liability, wherein the erstwhile partners would hold shares. The purchase price was to be paid by the partners (as sellers) by way of an allotment of shares to them and by crediting loan accounts in their names in the books of the company. These accounts did not bear interest and the capital thereof was payable to the sellers as and when the financial position of the company permitted. The partners, simultaneously, entered into a shareholders' agreement dealing with *inter alia* membership of the company, transfer of shares, salaries and directors' fee, loan accounts and rules of conduct.

Years later it became apparent that the company was lending large amounts each year to directors through salary and dividends. This amount was less after the incorporation of the practice than their incomes were before. Further, the amount received by the respondent as salary and dividend was sufficient to meet his normal living costs and that portion of his income he would normally have saved and invested was advanced to him by way of a loan to the company. The loans were made from the cash reserves of the company surplus to its requirements, the company having made large after-tax profits. In addition they were interest and security free. For the 1974, 1975 and 1976 tax years the respondent was assessed loss for tax on the income

[52] 1983 (3) SA 551 (AD)

actually accruing to or received by him. In 1978 the tables turned, the commissioner issued revised assessments for those years in which a proportionate share of the company's income was included in the respondent's income. In doing so he invoked section 103 of the ITA, contending that the incorporation of the company and loans to directors entitled him to exercise his powers thereunder. The tax payer's appeal to the Special Court was allowed and the Commissioner proceeded to the Appellate Division.

No doubt a transaction, operation or scheme entered into or carried out. The incorporation of the practice fell *ipso facto* as a scheme, so was the granting of the loans to directors. The Commissioner relied on the following pointers to justify his contention that the sake of the partnership practice was abnormal: one, the sale of assets to the partnership to the company on credit interest free; lending of large sums to shareholders interest free and without definite conditions of payment; and finally, conclusion of service contracts between the company and it's shareholders in terms whereof no set remuneration was stipulated and respondent received a much smaller salary than his previous income.

Corbett J in dismissing the submission said[53]:

> " As to the arrangement that the payment of the purchase price was to be made only as and when the company was in a financial position to do so, there is little else ... the parties could have done. Initially the company had over limited capital and the idea was that it would pay off the purchase price out of profits. This it proceeded to do over a period of six to seven years. Since the sellers were the persons mainly instrumental in earning those profits and were in complete control over the company, it was perfectly sound and businesslike arrangement. It was ... [one] that would normally have been created by persons dealing at arm's length .... the same goes to for the non-payment of interest on the purchase price. [N]one-payment [thereof] increased ... profits of the company; and this directly benefited the erstwhile partners as shareholders in the company for it enabled [them] ... pay off the purchase price more rapidly. Likewise, ... there was ... no abnormality in the fact that that the erstwhile partners gave their services to the company for no previously stipulated salaries. As controllers of the company they were able from year to year to determine in their own interest what their salaries were to be".

[53] , at 574G-575A

The question raised by the appeal in *Hicklin v. Secretary for Inland Revenue*[54] was whether or not the Secretary justifiably invoked the tax avoidance provisions of section 103 of the ITA for the purpose of attributing liability to the appellant for tax on part of the distributive profits of a dormant, private company of which he had been a shareholder. The relevant facts can be summarised as follows: the appellant and two others, P du T Viljoen and GW Milroy, were the shareholders and directors of Reklame (Edms) Bpk, "Reklame", registered in 1968. The ratio of the issued shares was 74, 18 and 8 per cent respectively. Reklame's main activity was management of Adverto (Pty) Ltd., "Adverto", an advertising agency, wherein it held 40 per cent of the shares. Reklame's income or profits, from inception, were used as working capital for Adverto or investment if a suitable business opportunity arose. No dividends were declared or paid out, hence accumulated as undistributed profits which in 1971 was R97 000.

In March 1971 Reklame and Adverto sold their business to a new company in which an overseas advertising agency, appellant and his two co-shareholders acquired shares. Reklame received R150 000 for the sale of its business. This was a capital accrual hence reflected in the balance sheet as a "non-distributive reserve". The new company, "the new Adverto", assumed the name of Adverto for goodwill purposes. The old Adverto changed its name to P. Viljoen Advertisers (Pty) Ltd., "Viljoen Advertisers", and later became the wholly owned subsidiary of Reklame. Reklame's balance sheet of February 1972 showed an investment by it of 4000 R2 shares in Viljoen Advertisers at a cost of R 100 000. As a result whereof both Reklame and Viljoen Advertisers became dormant companies. Thereafter Reklame borrowed money from Viljoen Advertisers which stood at R94 742 by December 1974. These interest free loans were to be paid "when funds became available". From time to time, the appellant and his co-shareholders caused Reklame to make interest-free and unsecured loans to them, roughly proportional to their shareholding in Reklame. By this action the shareholders did not consciously or deliberately use its distributive profits for the purpose but used any sources of money that happened to be available in Reklame then. These sources included the amounts paid from time to time by the new Adverto in respect of the R150 000 and loans from Viljoen Advertisers.

[54] 1980 (1) SA 481 (A)

At the 1973 Annual General Meeting it was resolved that a dividend should be paid out of Reklame's distributive profits. This would have been subsequently set-off against the shareholders' loans. However the proposal never materialised. The real reason, according to the Appellant and Viljoen, the major shareholder, being because the shareholders would have become liable to income tax on it. However the Director's Report blamed the non-payment on "the money market generally". The difficulty facing the appellant and other shareholders was what to do with the dormant Reclame with its large loans to them. According to the appellant the company was "untidy", that is, in business terms, not operating. To get rid of the untidiness, they decided sell it off to Ryan Nigel Corporation Ltd. "Ryan Nigel".

In anticipating this sale the appellant and his co-shareholders took steps to put Reklame into a warranted state, as required by the sale agreement. By their resolution of June 1975 they acquired from Reklame its investment of 4000 shares in Viljoen Advertisers for R100 000 and its outstanding indebtedness to the new Adverto. Against this they assumed Reklame's liabilities to sundry creditors and its loan from Viljoen Advertisers. The specific amounts were debited and credited respectively to their existing loan accounts with Reklame in proportion to their shareholdings. The net result was an increase in their loan accounts whistle Reklame was cleared of its other assets and liabilities. The assets totalling R249 786 were represented in the balance sheet of June 1975 by the issued share capital R2 880, the non-distributive reserve R150 000, and the distributive R96 906. Hence at this late stage it was correct, as the appellant conceded in testimony, that the loans must be regarded as having come partly out of the distributive profits. Thereafter Reklame passed completely out of the hands of the appellant and his co-shareholders. They did not retain any association with or interest in it or any control over its affairs.

In the year of assessment ended February 1976 the commissioner expressed opinion, in a letter, that:

> "the payment you received from Ryan Nigel .... for your interest in Reklame ... was received as a result of a scheme which falls within the scope of s 103 of the [ITA] 1962. Consequently your share of R8 072 in the total distributable reserve of R96 906 is regarded as a dividend received (and) taxable in your hands".

Appellant objected thereto and the respondent duly disallowed the objection. A further appeal to the Special Court having being dismissed the respondent sought recourse to the Appellate Division. It is worth noting that under section 86A of the ITA the Appellate Division can interfere with the Special Court's decision and substitute its own opinion if it is of the view that the same is erroneous in both law and fact. Previously it could only do so if the that decision was erroneous in law[55].

The court placed reliance upon the appellant's *ipse dixit*. The appellants conceded that their purpose was to rid themselves of the "untidy" Reklame. Before allowing the appeal a finding was made that the parties had dealt with each other at an arms' length. The court approached the matter from the premise that a taxpayer was "perfectly entitled" to avoid tax[56]. It proceeded to hold that abnormality was an independent requirement for the operation of section 103(1). The section was ousted where a transaction fell within the limits of normality even if the taxpayer's sole purpose was to avoid tax.

I feel inclined to contrast this decision with that of the former Appellate Division in *Commissioner of Taxes v. Ferera*[57]. Facts here were similar to those in *Hicklin* with the taxpayer admitting that his sole or main purpose was tax avoidance. His argument was that the general anti-avoidance provision, almost equivalent to the South African provision, could not be applied as the abnormality requirement had not been met. The court while branding tax avoidance an evil, at 656F, held that it could not have been the Legislature's intention to allow a taxpayer escape taxation if he admitted his sole purpose as being avoidance of tax. Further the abnormality test was held not to be a separate requirement, but functioned as circumstantial evidence on which the commissioner could base his attack that avoidance was the sole or main purpose of a transaction[58]. Was this an attempt to promote honesty in taxpayers? Should the law not be left to operate on it's own? otherwise how is one to determine the "evil" or otherwise of a transaction?

The final case under this head is *SIR v. Geustyn, Forsyth Jourbett*[59]. The facts which were as follows: PJ Geustyn, KW Forsyth and JD de Jourbet, all qualified civil

[55] See the cases of *Gallagher and Geustyn*
[56] at 389 G
[57] 1976 (2) SA 653 (RAD)
[58] at 658 H
[59] 1971 (3) 567

engineers and members of the South African Association of Consulting Engineers, practised in a partnership as consulting engineers. The practice expanded and they later decided to form an unlimited company to take over the partnership business. The company was incorporated in May 1966 with unlimited liability pursuant to the companies Act. Assets and liabilities of the partnership were also assumed by the company, the respondent herein. In addition the respondent undertook to pay the partnership goodwill of R240 000 and employ the three partners at an annual salary of R10 000 each. The shares in the respondent were issued to the three former partners in equal shares, and they thereafter became the sole directors. The amount of goodwill was credited to the director's loan accounts in equal amounts. Save for a shareholder's agreement imposing, in the event of a former partner ceasing to be a shareholder, a restraint against practice unless he forfeit his share of goodwill, no written agreements were concluded between any of the respective persons concerned. Particularly, no service contract was entered into between the respondent and the former partners. The respondent furnished no guarantee for the payment of the goodwill, the former partners relying solely upon their control of respondent to secure such payments.

In determining the respondents liability, for normal tax, for the 1967 year of assessment, the Secretary, invoked section 103 of the ITA. What this implied was that the whole of the respondent's taxable income was allocated to its three shareholders, namely PJ Geustyn, KW Forsyth and JD de Jourbett. The respondent objected which objection the Secretary overruled. Following his appeal to the Transvaal Income Tax Special Court the court held that the circumstances of the case did not rightly fall within the ambit of the Act, there was nothing abnormal with the transaction. The assessment was consequently set aside and remitted to the Secretary for amendment, but who instead appealed against this finding.

The leading judgement was given by Oglivie CJ with Holmes JA, Jensen JA, Rabie JA and Corbett AJA concurring. The Chief Justice has this to say, at 572H-573A-B, regarding a party wishing to attack a decision of the Special Court given pursuant to sec 103(4) in relation to what is in reality their income:

> "[One] can only succeed if they show that the Special court's conclusion is one which would not reasonably have been reached or, ... that the true and only reasonable conclusion contradicts the determination made ..."

The main contention of the Secretary was the transactions aforementioned were abnormal. The secretary criticised the formation of the company by the partners and more specifically attacked the disparity between the partnership's earnings and the salary of R10 000 p.a.; the R240 000 goodwill; absence of any security thereof of stipulation governing payment at any particular time; absence of any service contracts binding the former partners to continue working for the respondent. The cumulative effect thereof which would reveal that the transaction in question was both abnormal and established rights or obligations "would not normally be created between persons dealing at arms' length". Oglivie CJ's response thereto was, at 573G-H:

> "[T]here is nothing abnormal in transferring an existing partnership business to a company: indeed, such a transaction, may, ... be fairly regarded as relatively commonplace in the commercial world. That professional men carrying on their profession in partnership should transfer their practice to an unlimited company may no doubt at first sight appear to be somewhat extraordinary. In the present case, ... the undisputed facts place a different complexion on the matter. Not only has the South African Association of Consulting Engineers ... expressly sanctioned it's members forming unlimited companies to conduct their practices, <u>but more than half the Association's membership has already adopted that form of practice</u>." (Emphasis mine)

According to the court, therefore, if a majority of people in South Africa transact in a certain manner then such a transaction(s), despite having tax avoidance effects, will be regarded as normal. The Chief Justice extended the perspective into the international arena while observing[60]:

> "[This practice is not] peculiar to the Republic [of South Africa only]; .... the majority of consulting engineers in England, Canada, France, Switzerland and Japan practise in corporate from".

And concluded:

[60] at 574A

> "[T]he stated case shows that the erstwhile partners regarded as considerable the advantages to be derived from incorporation, as contrasted with partnership which was liable to dissolution consequent upon death, resignation [among others].... Such advantages *inter alia* embraced the facility of participation in consortiums of engineers engaged upon large projects the ability to increase the participation in profits by qualified engineer-employees while, [simultaneously], eliminating the necessity to restrict the number of partners to the legal limit of twenty."

Conclusion could not be escaped that the appeal had to fail on this ground.

Alternatively the commissioner under the normality test and while regarding the circumstances under which the transaction, operation or scheme was carried out or entered into, might seek to consider weather the rights and obligations created are those which would normally be created by persons dealing at arm's length. This is where I will delve into next.

2.2.2.2: ARM'S LENGTH TRANSACTIONS AND RIGHTS CREATED THEREUNDER

Under this test the question is weather the rights or obligations created are which would not normally be created between persons dealing at arm's length under a transaction of [that] nature subsection 1(b) (ii). The ITA does not define what amounts to an "arm's length" transaction. This phrase normally refers to dealings where the contracting parties view each other as strangers rather than relatives. Hence the dealings will be strictly with the purpose of profit making. The words "arm length" as an analogy refers to the distance the parties should observe in while transacting, that is the arm distance. They should get very proximal or be close to one another while transacting. The test here is objective, the prime question being what a reasonable person in those circumstances would do. Consideration is given to the purpose with which the scheme was carried out and what it intended to achieve.

The burden of proof falls on the tax payers to prove that the commissioner's determination is arbitrary. That the commissioner abused his discretion. Some of the standards used in determining the arm's length quantum, borrowing from the American jurisprudence, are: methods employed should not seem unreasonable[61]; the price should be fair including a reasonable profit[62]; and the consideration should be fair and reasonable. In the *Meyerowitz* case the scheme had was found to have *inter alia* created rights and obligations that would not normally have been created by persons dealing at an arm's length. This is due to the fact that the consideration paid by the partnership to the company for it's rights were trifling, not such as would be paid by persons dealing at arm's length with one another. This principal does not find its way in the business purpose test since this, presupposedly, forms the basis upon which such transactions are based.

Either test in subsection 1 part (I) and (ii) gives the Commissioner *locus standi* to proceed with the tax avoidance inquiry. Courts, on their part, seem to have been inclined to treat the two tests as a single one and simply ask weather or not the transaction is normal[63]. The test for abnormality from the above is two fold, one consider the circumstances and secondly nature of the transaction. I shall now proceed to the final test that the commissioner must fulfil, that is, the main purpose of the transaction was not solely or mainly to obtain a tax benefit.

2.2.3: THE PURPOSE TEST

This refers to transactions entered into or carried out solely or mainly to obtain a tax benefit, as provided for under subsection (1)(c).This factor is an overriding condition precedent to the applicability of the entire section. Reference is to the purpose of the taxpayer's purpose vis-à-vis that particular transaction. The test here is subjective with each case being determined on its own merits. Consideration is given to the purpose with which the scheme was carried out and what it intended to achieve.

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61 *Motor Securities Co. Inc. TC Memo., Docket No. 31656*, entered Oct. 30, 1952
62 *Grenada Industries Inc*, 17, TC 231 (1951)
63 See ITC 963 24 SATC 705

the onus falls on the taxpayer to discharge this rebuttable presumption and prove that tax avoidance was not the main or sole purpose.

Section 103(1) has an odd set-up. First it imposes an objective business-purpose test followed by a subjective purpose test. As William's succinctly puts it, "a taxpayer whose transaction fails the objective business-purposes test may conceivably escape the provision if he, subjectively, did not possess the requisite sole or main purpose of tax avoidance[64]. I pause the question, was this the intention of the Legislature or just an interplay between the two tests? In seeking a response to this query I will now move to analyse some decided cases on this front. Suffice it to note that tax planning hereunder is thus two-pronged. One, ensure there is a '*bona fide*' business purpose other than obtaining a tax benefit in ones transactions, operations or schemes. And secondly, get it right at the first instance. Later restructuring(s) to secure tax benefits might bring one within the scope of section 103(1). It is also worth noting that this is an area of the statute which has attracted sizeable amount of litigation.

Regarding the effect and purpose requirement the court in *Hicklin's* case held that it was not satisfied. Reklame being a company was in the eyes of the law a juristic person with its own personality, separate and distinct from its shareholders. Hence the judges observation, at 494B-C that:

> "... in law therefore it's distributive profits did not belong to the shareholders until declared as dividends".

The agreement was found to be genuine and *bona fide*, not a sham nor simulated transaction. The court further observed that, the taxpayers "were perfectly entitled to try to avoid liability by adopting some other legitimate courses"[65]. In expressing this view this court is not alone. Similar sentiments were expressed in *CIR v. Estate Kohler and Others*[66]. Thus it does not necessarily follow that, because a transaction, operation or scheme was aimed at and had the effect of avoiding an anticipated tax, it is hit by the provisions of s103(1).

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[64] Williams RC op cit Note 42 p678
[65] At 494G.
[66] 1953 (2) SA 584 (A) at 591F-92H

In *Boots Co. (Pty)Ltd v. Somerset West Municipality*[67] a truck driven by J, was involved in a collision with a motor car driven by N, they being employees of the defendant and plaintiff respectively. Both asserted that the collision was solely caused by the other's negligence. The plaintiff claimed that in terms of a lease agreement between it and H company, it was the legal possessor of the motor car hence liable for the risk of any damage. The defendant while disputing this alleged the plaintiff lacked *locus standi*. The court had opportunity to peruse two identical lease agreements relating to the same car. One between H company and plaintiff, earlier one, and later H company and N. Under the first agreement N was entitled to use a company car as part of his employment package. He was not party thereto.

Save for the parties, there was no substantial change in the second agreement. Car hire and insurance charges still vested on the plaintiff, further when N left the plaintiff's employ he returned the car and logbook to the plaintiff not H company. According to evidence, this agreement was necessitated by the then prevailing doubts regarding tax laws affecting fringe benefits. The question was weather it would be more favourable, for the employer, to provide a company car for use by the employee or pay them a car allowance. Both ways the company appeared to have taken the requisite precautions.

The plaintiff averred that the second agreement was spurious executed strictly for "tax purposes". According to the financial director of the plaintiff, "there was no intention ... to abandon the prior agreement, novate or substitute it with the second"[68]. One of the issues before the court was weather the first agreement constituted the only true contract between the parties. In such instances courts, in determining rights under the agreement, normally strive to give effect to the true intention of the parties and not form it purports to take. This is while recognising the purpose of the disguise being to deceive or conceal the real transaction between the parties. While bearing this in mind Comrie AJ applied the law in the following terms:

> "[T]he second agreement was not genuine but a 'tax dodge', [it was a document which would have been produced to mislead the *fiscus*, if necessary; ... the car arrangements with medical representatives, and in particular N, remained unchanged; there was never a car allowance

[67] 1990 (3) SA 216
[68] ibid at 219

scheme .... the prior arrangements between the plaintiff and H company, and plaintiff and N were adhered to up to the time when the jetta was finally sold to a third party"[69] (Emphasis Mine).

The Judge, in adopting the substance over form approach and while referring to the financial director continued,:

> "[He] was in particular a candid witness and I think an honest one. He may have been reluctant to admit a potential fraud [which] was understandable [since it] never actually relied upon *vis-à-vis* the revenue[70]."

A scheme designed solely or mainly to achieve business objectives rather than tax avoidance cannot be hit by section 103 even if tax savings flow therefrom incidentally. Neither does the section apply where the Commissioner has not offered any opinion as he's required to nor issued any assessments[71]. Let us take an instance where a taxpayer has more than one option with which to transact, 'in the context of business'. He thereafter bases his choice on the one offering the greatest tax benefit, rather than that *bona fide* business purpose. Can the Commissioner invoke the section against him? I think not. Would this not fly directly in the face of Lord Tomlin's dicta in *Commissioner of Inland Revenue v Duke of Westminster*[72]. It is trite knowledge that, "[e]very man is entitled if he can to order his affairs so that the tax attaching under the ... Act is less than it otherwise would be".

According to William's, "[where a] taxpayer has a choice between two or more types of transaction, or more than one 'manner' of entering into a transaction, then provided there is a *bona fide* business purpose to the transaction or ... manner he chooses, in addition to the tax benefit, ... section 103(1) will not be applicable"[73]. A court in such instances must first take cognisance of the circumstances of the particular taxpayer and then ask whether, in those circumstances, the generality of taxpayers

[69] ibid at 220I-221A
[70] ibid at 221A-B
[71] ITC 1274 (1977) 40 SATC 185 at 197. In the Zimbabwe High Court decision of *R Ltd. and K Ltd. v.COT* 45 SATC 148 it was similarly held, at 165, that adopting a scheme attracting less tax does not *ipso facto* infer tax avoidance as the main object.
[72] (1936) AC (HL) at 19
[73] Williams RC Note 42 p681

would normally have entered into the given business transaction, or entered into it in the given manner, for *bona fide* business purposes other than the obtaining of a tax benefit. If the answer is not in the affirmative, they would not have, then - irrespective of whether it was the business purpose that attracted the particular taxpayer- section 103(1) will be applicable.

Looking at the case of *H v. COT*[74]. The appellant and his wife virtually the sole shareholders of four trading companies. To avoid payment of undistributed profits tax[75] he created two companies A and B and a parent company. The sole source of income from the parent company was from A and B, while A and B derived theirs from four trading companies he had formed. The overall result was, each of the seven companies would retain a third of their profits in undistributed form without attracting undistributed profits tax. However the aggregate amount remained in the coffers of the four trading companies instead of being divided, which four companies would have been liable for undistributed profits tax.

What were the implications of the taxpayer's act? During the years in question taxpayers in the higher income tax group were subjected to a special tax, supertax, levied on income exceeding a certain amount. Those who derived most of their income from dividends declared by companies they controlled resorted to not declaring dividends they would normally have. Instead they left profits from which dividends would have been declared in a company's kitty in the form of undistributed profits. To counter this move Fiscus introduced the undistributed profits tax. However companies could still retain, for its ordinary business activities, a upto a third thereof as undistributed profits. Hence the appellant in this case was able to retain a third of its profits undistributed in the companies without attracting tax. Whereas had the aggregate amount of undistributed profits remained in the kitty of the four trading companies, instead of being divided among seven, they would have been liable for undistributed tax. The Commissioner sought to cut the pipe line and left the trading companies and treated the dividends they had declared as if they were paid directly to the appellant. Beadle CJ in summarising this matter observed:

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[74] 1972 (2) 719

[75] This would have been hit by the then section 98,substancially equivalent to section 103 (1) (c) in the present Act in case "he deems" the scheme as intended to avoid tax.

> "The appellant contends that all [the] dividends which were declared or deemed to have been ... by the parent company in [the] years in question were all from profits which had come up to it via companies A and B from the trading companies. [A]s the respondent was now taxing in full all these profits, those amounts representing dividends from the parent company were being subjected to double tax"[76].

By taxing only the legitimate part of the income fear of double income taxation is extinguished. Hence the Commissioner was justified in cutting the profit pipeline between the trading companies and their parent. There is only one source from which the money from these dividends could have come from and that is in the form of undistributed profits standing in to the credit of the parent company, and if the dividends were paid out from [the] undistributed profits and not from the profits coming from the trading companies ... there is no double taxation[77]. The appellants appeal inevitably failed and was dismissed with costs.

In the case of *Meyrowitz v. Commissioner of Inland Revenue*[78] the Appellant, an Advocate, also doubled up as an author. During the years 1948 and 1953 he produced two books, Estates and The Hand Book of Transfer Duty. Both sold well and profits therefrom, as per the agreement, shared equally between him and the publishers, Juta and Co. Ltd. He also engaged, in 1952, in publishing a monthly journal, *The Taxpayer*, together with his two associates, Silke and Spiro. This was under the aegis of their company, "The Taxpayer (Pty) Ltd.", hereinafter referred to as T Ltd.. This venture also proved to be a success. He subsequently decided to form a Company, Visandra Investments (Pty) Ltd., herein after referred to as V Company, to assume his rights, title and interests in the two aforementioned text-books. The shareholders of this Company being the appellant and his spouse, each held one share. In March 1952 he ceded to this Company, for no consideration, all his right, title and interest in and to the two text-books. In addition his contracts with Juta concerning them. Later in the same year Meyerowitz Trust, herein after referred to as M trust, was formed. The appellant's father by a deed of donation donated 50 pounds to the appellants three minor children, in equal shares, to be held for them in trust, in M trust.

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76 supra note 10 at 722F-H
77 ibid at 724B-C
78 1963 (3) SA 863 (A)

In September 1952 V company ceded all its right, title and interest in and to the appellant's two books to M trust, plus the Juta contracts concerning them. The Trust paid a consideration of 75 pounds.

In October 1952 a partnership, Legal Publications, hereinafter referred to as the partnership, was formed between Spiro, M trust and Silke trust. (The latter having been created in favour of Silke's minor children). The profit sharing ratio was pegged at 20:40:40 respectively. In October 1952 a tripartite agreement was entered into between the partnership, T Ltd. and Juta in terms of which the partnership was substituted for the company under the latters agreement with Juta. The partnership paid the company a sum 32 pounds for the acquisition of these rights, and thereafter took over production of *The Taxpayer*. Silke, Spiro and the appellant continued to be employed as editors at a fee of 300, 305 and 200 pounds per annum respectively. In the appellants 1959/60 year of assessment the appellant only reflected in his income the editorial fee of 200 pounds. He did not, however, include in his returns any of the profits, as royalties and share in partnership, derived from the sale of his books. These were reflected, instead, in the returns of the M trust.

The Commissioner opined in that the appellant had entered into these transactions with the object of avoiding tax. While availing himself the powers conferred under section 90, almost equivalent to the current section 103 (1), he proceeded to include in his income the amounts returned by the Trust as his income. The appellant objected on the ground that the profits had not accrued to him and not subject in his hands under section 90.

According to the Special Court the series of transactions by the appellant, in the course of which he had ceded the agreements which he had with the publishers and which regulated the payment of royalties, to companies he had formed, was a scheme. Which scheme had the effect of avoiding liability for tax, had created rights and obligations that would not normally have been created by persons dealing at an arm's length. This conclusion was arrived at following the appellant having parted with valuable rights to V Trust without receiving any consideration therefrom. Tax avoidance was thus held to be the main purpose of the scheme. The *Taxpayer* transactions. However the scheme was found to have been carried in a manner which would not normally be employed. This conclusion was arrived at based on the fact that the appellant was still working and neither the trustee nor his children were competent to assist in the production of the *Taxpayer*. In the words of Watermeyer J, President of the Special Court, at 873C-D,

> "As a result of the series of transactions the income which the appellant would have received for his work and labour was transferred to his children."

Furthermore the consideration paid by the partnership to the company for its rights were trifling, not such as would have been paid by person's dealing at arm's length with one another.

The Commissioner, in the exercise the powers conferred, treated the appellant as if 40 per cent of the gross profits of the company had accrued to him. According to the Special Court, at 871B-C;

> "...[The appellant] ignored all the transactions, including the formation of T Ltd., on the basis that the whole scheme, including the formation of the company, was carried for a tax avoidance purpose".

The overall result would be payment of more tax than he would have had the scheme not been carried into. The learned judge, Watermeyer J, continued by saying;

> "I have not lost sight of the fact that the liability for tax payable by a company is indirectly borne by the shareholders, because the amount available for distribution to them is thereby diminished. [B]ut a company is a different legal *persona* from it's shareholders and the only tax payable by the shareholders is upon the income which they receive by way of dividend."

The assessments were thereafter set aside in respect of the amounts accruing from the publication of *The Taxpayer* and matter referred back to Commissioner to re-assess. It is from these findings that the taxpayer appealed. The vigilant Commissioner on the other hand cross-appealed against the finding that he had incorrectly determined liability for tax as regards *The Taxpayer*.

A full bench of the Appellate Division, Beers JA, van Blerk JA, Oglvie Thompson JA, Williamson JA and Hoexter JA, concurred with the special court that the appellants' series of transactions amounted to a scheme. In dismissing the appeal Beyers JA, who gave the judgement, summarised the whole scenario, thus, at 874C-E;

> "As the law then stood the formation of the company, from a taxation point of view, was pointless: the whole of the company's income would have been apportioned to the appellant for tax purposes. Within a week came [as] announcement in Parliament that the apportionment system was to be abandoned, to be replaced by shareholder's tax, and no provision made for taxing undistributed profits. This gave V Ltd. a *raison d'être*. [It's] formation and the cession to it of his rights may or may not have been a piece of intelligent anticipation on the appellant's part, but however..., the explanation which he gave for the formation of the company was not acceptable to the court".

What the Judge found unacceptable was the appellant's explanation that tax considerations played no part in the decision. This is because only the appellant and his wife were shareholders in V Ltd., and the total income of the company would have been apportioned to him for tax purposes. It consequently made no difference, from a tax perspective, whether the income accrued to the company or himself. The taxpayer was found to have 'avoided liability' for tax. It seems ... that the personal exertion of an individual constitutes a continuing source of income in itself which may not through mere interruption be viewed on a subsequent date as a 'new source'[79]. Hence in applying section 103 it seems that a court will have to consider the presence of antecedent labour productive arrangements remaining in force under the scheme which it is claimed to attack but whose effects are thereby varied. Alternatively weather there is a termination of these arrangements and a subsequent creation of novel one(s) with differing tax effects. As Clegg opines, "it may be relevant in so doing to have regard to the manner in which any antecedent arrangement or situation was terminated and in particular ... consider whether an alleged new source of income is indeed new or merely a reactivation of the antecedent source in a new guise.[80]

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[79] Clegg D *Section 103(1)- "Freedom of Choice"* 1 SATJ 1986 224 at 227
[80] ibid p 229

Regarding the exercise of Commissioner's powers the court posited, at 875D-G,:

> "In my opinion the commissioner was entitled to ignore completely "The Taxpayer (Pty), Ltd." It is true that the Special Court found that when it was formed there was no purpose of tax avoidance . [A]lthough it may have come upon the scene with good intentions, it ceased almost at once to be an innocent bystander. It became a party to the scheme when it ceded its only asset to the partnership: it was essential to the scheme that it should do so".

He proceed to add:

> "I must confess that I can see no real distinction between the role played by the T company in this scheme of things and .... by V in the other scheme. The company died ... in the service of the scheme and it seems to me to be illogical to hold that the commissioner ought to have ignored the company, but ... resurrected it for the purpose of determining the appellant's liability to tax. To now seek to re-invest the company with the income from *The Taxpayer* is to imply-contrary to the finding of the Special Court-that the cession of its rights to the partnership was a legitimate transaction and played no part in the avoidance-of-tax scheme".

And finally concluded:

> "In any event I consider that it was at least appropriate "in the circumstances of the case" for the Commissioner to have taxed the income from the *Taxpayer* in the hands of the person to whom in reality it belonged. To restore the company notionally to the register and then attribute to it a notional income would in these circumstances be an extremely artificial and unrealistic manner of determining the appellant's liability to tax. I cannot think that sec. [103(1)] intended such a result."

With that the appeal was dismissed and cross-appeal allowed.

I now turn to the case of *Ovenstone v. Secretary for Inland Revenue*[81]. The appellant was a member and Director of a family, which controlled a group of public companies, the group, interested primarily in the fishing concern in the then South West Africa, SWA. One of these companies was Ovenstone South west Investment

81 1980 2 SALR 721(AD). The "Secretary" referred to is of course the Commissioner today. this was the the title of the ofice before 1964 and was changed in 1980.

Ltd, shares of which were held by Ovenstone Holdings (Pty)Ltd. And Scotia Investments (Pty) Ltd., Scotia. These companies were registered in South Africa and SWA respectively. Suffice it to note that the dividends received from SWA were then income tax exempt under section 10 (1) *k* (vi) of the Act. In 1968 the appellant established The John Ovenstone Trust, the Trust, with a two pronged intention. First, for the benefit of his children and secondly to save on estate duty, otherwise payable upon the appellant's death. Evidence in the Special Court established, quite correctly, that at this stage his decision was not aimed at avoiding any liability for income tax, for none was then payable.

In 1969 the appellant became aware of Parliament's intention to repeal the aforementioned exemption section. This implied a substantial increase in his income tax liability. In his wisdom, or lack of it, "got things to move" by causing registration of Sandwich Harbour Investments (Pty) Ltd., Sandwich Harbour, in SWA in 1969. He was the sole director and shareholder holding its only two issued shares. So soon thereafter he sold his shares in Scotia and Ovenstone to Sandwich Harbour, which sale was verbal, unsecured and interest free. An almost equivalent amount was credited to the trust account, whereupon the appellant had sold the two issued shares. In this regard the Special court found,

> "the appellant received an amount equivalent to the dividends paid in respect to the shares he parted with, not as taxable income .... but as part payment for the purchase prices of the shares and therefore ... capital completely free of income tax.

The Special Court found that all requirements had been fulfilled in regard to the evidence led.

In the Appellate Division the appellant submitted the purpose test had not been fulfilled. When the scheme was mooted his sole purpose was saving on Estate Duty, which purpose was never abandoned at the implementation thereof. On this score the Special Court had observed:

> "We completely reject this [argument]. [W]e have no hesitation whatsoever in concluding ... that a scheme was embarked upon and implemented in ...1969, one of the objects being to avoid income tax."

The Appellate Division, as presided over by Trollip JA, found "some merit in [this] approach"[82], and proceeded;

> "[E]ven if the purpose or effect of the scheme when it was formulated [was] not to avoid liability for tax, it may have that effect or ... become the taxpayer's purpose when he subsequently carries it out, [then the commissioner can invoke section 103 (1) against him subject to the fulfilment of the other requirements]"[83].

The final nail was struck by the appellant's *ipse dixit*. Upon cross-examination he conceded knowledge of his scheme having the effect of reducing his income tax liability, and hence "moved on" without delay.

The learned Judge in arriving at his decision summarised the facts and evidence as:

> "The irresistible inference is, ... [w]hereas appellant's sole purpose in originally formulating the scheme was the saving of estate duty ... and additional[ly] ... avoid the anticipated new liability for income tax on the dividends in question."[84].

This was inferred by the hurried manner he carried out the scheme in 1969. Regarding onus the judge found;

> "At any rate because that resulted in the avoidance of such liability, the onus rested on the appellant under s 103 (4) to prove that the latter was not then one of his main purposes; and [which] he certainly failed to discharge ....[85]"

The Special Court's decision was rubber stamped by the Appellate Division.

According to Louw, in the *Louw* case the main reason for incorporation, according to the appellant was seek and hence enjoy the advantages accruing in a company over a partnership. Primarily continuity despite death or retirement of a member from the practice, and in addition easy incorporation of new members. The court *a quo* appears to have conscious of the need to measure the *ipse dixit* of the respondent, who ... was found a credible and candid witness, against their evidence and

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[82] at 731F

[83] at 732E while quoting Corbett J in SATC 29 at 36-7

[84] at 733B-C

[85] ibid at C-D

probabilities[86]. With this it found that the Appellant had successfully discharged the burden imposed upon him, despite achieving postponement of income tax. Corbett JA concurred with this finding. The respondent, in the eyes of the court, failed to rebut the presumption of his sole or one of the main purposes of granting these loans, in effect in lieu of salary and/ or dividend effectively postponing tax liability or avoiding the same.

2.2.4: COMMISSIONER'S POWERS

The Commissioners powers, once all tests are satisfied are two fold under section 103(2). One, the subjective test whereunder they are empowered to determine the tax liability in a manner "he deems appropriate". While interpreting the words, "he deems appropriate" the court in *H v COT* opined that a wide interpretation was intended, and said:

> "[The Commissioner] may, if he so wishes, pull down the whole [or part of an] artificial edifice ... erected by the taxpayer ... to avoid tax"[87].

Do these powers, which appear sweeping, accord a *cartre blanche?* I think not, the commissioner must act within the spirit of the Act's provisions. For instance they cannot impose a penalty not provided for nor charge interest, upon a penalty, at a higher rate than that prescribed by statute. The guiding beacon should be prevention or diminution of tax avoidance or reduction thereof.

In the alternative disregard the ghost or bubble transaction and impose tax. The Commissioner is empowered to assess the taxpayer on the basis of the fiction that the offending transaction had not been entered into or carried out. Little wonder this part of the Statute has been described by courts as having annihilating effects[88]. The

86 ibid Corbett JA at 576G-H
87 ibid at 723E
88 In *Newton v. FCT* (1958) 2 All ER 759 PC.

commissioner may unveil the transaction erected by the taxpayer to avoid tax. In the *Meyerowitz* case the court had this to say regarding exercise of these powers:

> "In any event I consider that it was at least appropriate "in the circumstances of the case" for the Commissioner to have taxed the income from the *Taxpayer* in the hands of the person to whom in reality it belonged. To restore the company notionally to the register and then attribute to it a notional income would in these circumstances be an extremely artificial and unrealistic manner of determining the appellant's liability to tax. I cannot think that sec. [103(1)] intended such a result".

If in the circumstances it is not appropriate to unveil the transaction the commissioner may elect to pull down a portion thereof and tax it on the basis that it never existed. The overall effect being taxation of only the legitimate structure of the taxpayer's business[89]. The Commissioner, in the exercise the powers conferred, in the *Meyerowitz* case treated the appellant as if 40 per cent of the gross profits of the company had accrued to him. I pause the question, does ignoring the transaction *ipso facto* create liability to tax[90]?

This provision, all the same, limit's the Commissioner from exposing the taxpayer twice[91]. All this is intended to prevent or reduce the avoidance postponement or reduction of liability. The name of the game is, he who alleges proves. Therefore the onus rests on the taxpayer[92] to prove he did not intend to postpone or avoid tax liability. The standard of proof being on a balance or preponderance of probability. Mere assertion that he did not intend to avoid tax will not suffice[93]. Compelling reasons for the same will, on an objective basis, and which should be good enough to have motivated the taxpayer's actions. Other considerations include time when the scheme is implemented and not when first conceived[94].

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89 See Smith's case

90 Australian courts have held that it had to be shown that, after the transaction had been ignored, money's had infact reached the hands of the taxpayer which the Commissioner was entitled to treat as income. *Newton* case *ibid.*

91 See also *H V.COT* 1972 (2) SA 719 (RA)

92 Under section 82 of the ITA the burden of proof that an amount is not liable to any tax chargeable is on the taxpayer. See also *L v. COT* 1970 (2) SA 64 RAD

93 See *Gallagher & Ovenstone*

94 See *Meyerowitz and Smith.*

In this Chapter the main point of discussion was section 103 (2) of the ITA and the tests the commissioner must fulfill before seeking to invoke the section against a taxpayer. Namely the taxpayer should carry out or enter into a transaction with the main or sole purpose of avoiding anticipated liability for tax, and whose effect achieves the same. The commissioners' powers have also been discussed. Though *prima facie* they seem to grant the commissioner a *carte blanche* in fact they do not. The powers are exercisable to the extent that they seek to prevent payment of tax as imposed by the ITA. Regard has also been had to the legal opinions from courts as well as legal commentators.

CHAPTER III

TRAFFICKING IN ASSESSED LOSSES

3.1: INTRODUCTION

Taxable Income of a person, is generally the net product of their income less the amounts allowed under Part I of Chapter II of the ITA, to be deducted from or set off against such income[95]. While income, under the interpretation section of the ITA, refers to the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part II of Chapter II. A loss would ordinarily arise where the amount of deductions exceeds the income received or accrued. Such losses under section 20(1) of the IT are to be set-off against income received or accrued in subsequent years. This has been a channel taxpayers have sought to utilise to avoid tax. This is where my discussion will proceed to next.

3.2: ASSESSED LOSSES AND BALANCE OF ASSESSED LOSSES

According to the interpretation section of the ITA, section 1, a loss becomes an assessed loss once the Commissioner brands it as so. This is not so helpful a definition,

[95] See section 1 of the ITA also.

hence recourse to section 20(2). Thereunder 'Assessed Loss' is defined as any amount which the deductions admissible under sections 11 to 19, inclusive exceed the income in respect of which they are so admissible .... The term 'Balance of Assessed Loss' is not defined by the Act either. Case law has defined the same as: the excess of an assessed loss brought forward from the preceding year of assessment over the income of the current year[96].

What is envisaged by the ITA is a situation where the taxable income of a subsequent year is more than swallowed up by the assessed loss of a previous year[97] It is this balance that may be carried forward in the succeeding year. Where one has brought forward an assessed loss from the preceding year, it is added to the current year's loss. The aggregate thereof represents the balance of the loss to be carried forward to the following year's assessment and set-off from the arising income, if any. This is an exemption to the general rule that income tax operates on an annual basis with each year of assessment being taxed as a closed compartment[98].

Under such circumstances, from a tax perspective, no tax can be levied in that year of assessment since there is no income on which it can be based. In other words, one cannot be expected to pay tax on negative income. Secondly, as provided for under section 20(1)(a) of the ITA, such a loss, or balance thereof, will normally be carried forward to be set-off against gross income of later year(s).

An assessed loss becomes an asset for the following year since the taxpayer enjoys a 'tax-holiday' for the amount of loss carried forward. In companies it is a tax saving stratagem particularly where the shares of a company with a loss are purchased by a prosperous one. The overall result to the new company is saving tax on the loss the moment it seeks to set-off the same from its income in a particular year of assessment. For non-companies Revenue has nothing to fear as the loss(es) are not transferable. The principle relating to set-off of assessed losses, in section 20, distinguishes between companies and persons other than companies. To be allowed to set-off its losses the company must "carry on any trade within the Republic ..."[99] in the

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[96] SA *Bazaar(Pty) Ltd. v CIR* 1952 (4) SA 505 (A)

[97] See Emslie TS et al *Income Tax Cases and Materials* The Taxpayer: Cape Town 2nd Ed, 1995 819 while criticising Ingram KC's interpretation of the same in ITC 664 16 SATC 125

[98] Williams RC op cit Note 42 p 329

[99] section 20 (1)

year it seeks to setoff the loss. Is this not a discriminatory provision of the Act against companies? In the words of Centrelivres CJ in *SA Bazaars (Pty) Ltd. v. CIR*[100]:

> "During the [relevant] year ... the appellant did not carry on, within the meaning of sec. 11(1), [equivalent of sec. 2], trade within the [Republic] and it derived no income from any trade. As the appellant carried no trade it was not competent .... to set-off in its income tax return for that year the balance of assessed loss incurred by it in the previous years." (Emphasis mine)

Beyers JA in *New Urban Properties Ltd v SIR*[101] in finding that the balance of assessed loss could not be set-off against income for the 1959 tax year said:

> "In the *SA Bazaar* case, supra, that interruption occurred through the taxpayer's ceasing to trade in a particular year. In the present case it has occurred through the operation of sec. 90 (1) (b) which prohibited [this] balance ... from being set-off against the only income received by the appellant, in respect of the trading activities conducted by it ... In other words, although the respective causes of interruption were different, the result under sec. 11(3) was the same in each case. [The appellant had not fulfilled the carrying on of trade requirement]"

The full facts, in *New Urban Properties*, were, by the 1958 year of income the taxpayer had balanced accumulated loss of 767709 pounds. In 1959 the company's shareholding changed hands shifting to five parties, four individuals and one company. This gave them *de facto* control, with the four individuals becoming directors. Previously these shareholders held no shares in the taxpayer company. Before the change in shareholding the company was dormant. In its 1959 year of assessment the company earned income which it sought to set-off from the balance of assessed loss. The Secretary disallowed the set-off. The most possible ground being, that the acquisition was with the intention of channelling income from their own companies to the taxpayer with the object of setting it off against the assessed loss, thereby avoiding tax which that income would otherwise attract.

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[100] 1952 (4) SA 505 (A.D) at 510. See also *Sub-Nigel Ltd. v. Commissioner for inland Revenue* 1948 (4) SA 580 (AD) at 590 which cited this case with approval.
[101] 1966 (1) SA217 (A)

An interesting question emerging from this decision is weather the assessed loss could have been carried forward had the court found that the separate trading activities could not be traced to the change in the shareholding[102]. This could have arisen, for instance, had these activities been carried on prior to the change in shareholding. Carrying on trade, according to Kirk-Cohen J, president of the special court in ITC 1476[103], involves an active step. Something far more than merely watching over existing investments that are not intended or expected to be, income producing during the year in question.

The way in which the concept of assessed loss or balance thereof work was explained by Schreiner, ACJ in *CIR V. Louis Zinn Organisation (Pty)Ltd.*[104]:

> "Whenever there is a trading loss in the tax year, or ... balance [thereof] brought forward from the previous year, there has to be a determination of the balance of assessed loss to be carried forward into the next year. There may have been a profit in the tax year, but not large enough to obliterate the balance of assessed loss carried over from the previous year. Then the new balance ... will be smaller than the previous one. If there has been a working loss in the tax year the balance to go forward will be increased. If there has been no previous balance the assessed loss in the tax year will be the balance of assessed loss carried forward.

While in the words of Emslie TS, a tax commentator:

> "The scheme of s 20(1) seems ... to be that one is required to ascertain the taxpayer's taxable income or the assessed loss from each trade separately, and then aggregate the assessed loss or taxable income from every trade carried on in order to arrive at the overall position for the current year: either an assessed loss or taxable income. Thereafter any balance of assessed loss carried forward from the previous year must be set off against the current year's taxable income, if taxable income it is, or added to any current year's assessed loss, if such it be, to arrive at either (a) the taxable income on which normal tax will be levied for the year, or (b) the balance of assessed loss to be carried forward to the next

[102] Stewart DM *The Prohibition of Tax Avoidance: An Evaluation of Section 103 of the South African Income Tax (No 58 of 1962)* Comperative and International Law Journal of Southern Africa, vol 3 1970 168 at 192
[103] (1989) 52 SATC 141 at 148
[104] 1958 (4) SA 477 at 485

> year of assessment. ... This approach .... places reliance on the role of s 20(1) (b) in the interpretation of the subsection as a whole".

I hasten to add that in addition such a company must fulfill the trade requirement.

2.3: ASSESSED LOSSES AND THE GENERAL ANTI-AVOIDANCE PROVISION

Companies wishing to take advantage of this tax saving stratagem face potential hurdle in the form of section 103(2), the anti-avoidance provision The Commissioner, thereunder is empowered to refuse the set-off of any assessed loss or balance [thereof] against income derived, upon satisfaction, any agreement affecting any company or ... change in shareholding [therein] ... or in the members' interest in any company [with] a close corporation[105], as a ... result of which income has been received by or has accrued to that company ..., been entered into or effected by any person solely or mainly for the purpose of utilising any assessed loss or balance [thereof] incurred by the company , in order to avoid liability on the part of that company or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof.

The object of subsection 2 was stated by DM Steward[106]:

> "The reason for this subsection is that elsewhere in the Act (s20) it is recognised that to divide a taxpayer's business up into separate yearly compartments is largely artificial, and as a result, where in one year allowable deductions exceed income, the taxpayer may carry the balance of deductible excess forward as an "assessed loss". This loss may be deducted from income earned in the next or a subsequent year. As a result, certain taxpayers, whose businesses have failed to profit, build up large assessed losses".

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[105] A "corporation"is defined under the Close Corporation Act, No. 69 of 1984, as a close corporation referred to in section 2(1) as registered under Part III of the Act. Under the section 2(1) a close corporation is formed by one or more persons, but not exceeding ten.

[106] In *TheProhibtion of Tax Avoidance: An Evaluation of s 103 of the South Afcan Income Tax Act 58 of 1962* (1970) 3 CILSA 168 at 189.

This proposition was lauded with approval by the majority holding in *Conshu (Pty) Ltd v CIR*.

The section is very broadly worded to cast the of tax collection as wide as possible. This can be perceived from the use of the word "whenever" in the introductory part. All the same this power is subject to limitations. For the commissioner to be able to invoke it there must be, one, any agreement affecting or change in shareholding in any company or in the members' interest in any company which is a close corporation. Words " any agreement affecting any company" are widely stated and taken at face value bound to bring within the net almost every transaction entered into by a company, whether or not such agreements have any effect upon the shareholding of the company. What the taxpayer needs to show is that he had good reasons for entering into the agreement or effecting the change in shareholding, and the assessed loss was subsidiary thereto. Alternatively, weighed equally with the other reasons, the set-off passes the sieve test. And secondly as a result of which income is received or accrues to that company. The legal interpretation of the words describing the transaction has been a seedbed of litigation.

Third, the "main or sole purpose of entering into the agreement being utilisation of any assessed loss of balance thereof incurred by the company". This, often referred to as the, 'purpose' test is normally a matter of fact. In practice it has been the most difficult requirement for the commissioner to fulfil[107]. The onus is on the taxpayer to prove that although the transaction had the effect of avoiding or reducing tax, this result was merely a by-product and not the sole or main object. Case law, hereunder, indicates that, if tax avoidance is not the dominant reason, the taxpayer will be said to have managed to walk outside this requirement. Therefore where a company[108] in ITC 983, manufacturing and selling women's clothing, bought shares in another manufacturing company, and which had a loss, to meet its orders, a set-off was allowed. Watermeyer J at 58 said in terms of the equivalent of sec 103(2), that

[107] According to some Commentators this requirement provides the acid test as to weather or not section 103(2) may be applied
[108] ITC 983 (1961) 25 SATC 55

"for the section to operate the avoidance or reduction of tax must at least been the principal purpose of the taxpayer".

While referring to this case specifically he stated,

"[T]he court is satisfied that although the avoidance or reduction of tax was one of the purposes it was not the main [one]".

The main purpose was,

"to obtain a production unit which would go into the immediate production"

a purpose which the company indeed achieved.

In *Glen Anil Development Corporation Ltd. v. SIR*[109] the taxpayer company, A, was the subsidiary of company B, a subsidiary of company C, the shares in which were owned by company D. In 1966 one Dr. Rubenstein's children bought from D it's shareholding in and claims against C for R30 000. It was a condition of the sale that if A's assessed loss of R622947 as at 30 June 1964 had not been extinguished or reduced, the purchaser's would pay the seller a further R50 000. I wish to pause for a moment and comment on the implications of this arrangement. A possible tax advantage would accrue to A. The rate of income tax and loan levy on companies then was 33 % implying that the value of assessed loss to the appellant, if allowed, would have been R200 000 over as many years as its taxable income totalled R622 947. Neither A nor C owned any assets then. Subsequently A bought certain farmland and established a township thereon. During the 1966 year of assessment A derived income of R222 895 from its township business. However, the Secretary acting under section 103 (2) refused to allow him to carry it forward and set off the assessed loss of 1965 in terms of section 20 (1) (a) of the ITA.

The onus lay on the appellant to satisfy the court that the agreement in question was not entered into solely or mainly for the purpose of utilising the assessed loss in question in order to avoid liability for payment of any tax on income. In other words, weather on the facts set out a reasonable court would have come to the

[109] 1975 (4) SA 715

conclusion that the presumption referred to in section 103 (4) (b) was rebutted. The appellant contended that their sole or main purpose was ensure that all benefits arising from the development of future townships by Dr. Rubenstein would accrue, not in favour of his estate, but for the children through their shareholding in company C. Thus not form part of his estate for estate duty purposes. Secondly, take advantage of the benefits of the exemptions from undistributed profits tax then enjoyable.

Among the questions the Court sought answer included, why, if saving on estate duty was a major purpose, the claims were bought and the conditional agreement entered into. The court took cognisance of the fact that the children did not participate in the negotiations leading to the conclusion of the agreement nor testify, despite being liable to pay the accruing costs. "It would have been of some importance to know what they had in mind"[110]. To these I add, if the company was cash strapped, as it purported to be, why did it not re-invest, in the companies, by way of loan on the distributable profits?

Regarding the undistributed profits tax, it is worth noting that the same is only payable on the amount of distributable income of the year exceeding dividends distributable during the year. So that where all the income is distributed as dividends this tax is not payable. In this regard , "no explanation appear[ed] ... as to the apparent reluctance on the part of the group of companies to distribute its distibutable income"[111].

While referring to the aforementioned arrangement Botha JA analysed the situation further as:

> "On an annual income of R200 000 the appellant would, if the assessed loss were allowed, have saved approximately R200 000 in the income tax over a period of three years. The saving in undistributed profits tax would have amounted to approximately R10 750 per annum. To have saved the sum of R200 000 in undistributed profits would have taken approximately 18 years. If the companies were in need of cash money a saving of R200 000 in income tax over a shorter period would have been an important consideration. Even if the saving in undistributable profits tax arising from the appellant's deficit of R664 166 on profit and loss account is taken into consideration, the saving on income tax over a

[110] ibid at 734A

[111] ibid at 733H

> short period still [by] far exceeds the saving in undistributed profits"[112].

Bearing all these in mind the court found that the appellant has failed to discharge the onus, accordingly the appeal failed. This case seems to have led to the amendment of section 103 (2). Botha JA observed, at 729,:

> "I have already indicated that, for the purpose of the opening words of sec. 103(2), it seems clear that in the case of an agreement it can only be a company having an assessed loss, which is affected by or concerned with the agreement, and which receives any income resulting therefrom, that the Legislature could have had in mind. If, therefore the words "any agreement" in the opening words of that section were construed as if the words "affecting any company" were inserted after the words "any agreement", as I think they should be, the opening words of the section would make sense and would give effect to what in my view the Legislature intended".

The Legislature reacted by effecting these proposed amendments in sec. 103 (2) of the Act.

Turning to the case of *CIR v. Ocean Manufacturing Ltd.*[113] The respondent company rendered returns of it's income in respect of the 1981 and 1982 years of assessment in which it set off against its taxable income certain assessed losses. The appellant refused to allow this contending that it fell foul of the provisions of section 103(2) of the ITA. The respondent company had been the subject of a reverse take-over agreement in order to obtain for its shareholders and directors a 'back-door' listing on the Johannesburg Stock Exchange. In terms of clause 11 of the merger agreement which affected a number of companies and parties, the parties agreed that 'as soon as is reasonably possible hereafter the company, respondent, shall sell its business as a going concern to Model on reasonable terms and conditions'. Model was part of a group, B and P, which in 1979 had been restructured in terms of sec. 311 of the Companies Act 61 of 1973. By then it had accumulated an assessed loss that had been specifically mentioned in the negotiations leading up to the merger agreement. The Commissioner's submission, expectedly, was that, utilising the assessed loss was

[112] ibid at 734C- E
[113] 1990 (3) SA 610

the main or sole purpose of the transfer agreement. On this Nicholas AJA had this to say, at 618E-F:

> "[W]hat has to be considered is the purpose of the parties to the transfer agreement in entering into that agreement. It could not be disputed that the sole purpose was to utilise the assessed loss of Model holmes to avoid liability for tax, and that is abundantly clear from the statement of agreed facts. There could be no other purpose. With the completion of the reconstruction, Ocean, with its profitable business, became a fully owned subsidiary of B and P.... <u>[T]here could be no point apart from tax avoidance, in transferring that business to another fully owned subsidiary having as assessed loss</u>". (Emphasis Mine)

It is noteworthy that the Commissioner sought to invoke section 103(2) when there was no change in shareholding in the taxpayer company, but only an agreement through which an existing business that was conducted by the shareholders of the company with the assessed loss was diverted to the company with the assessed loss simply to avoid tax through the use of the loss.

While in ITC No. 1123[114], where the taxpayer's change in shareholding was held to have the sole purpose of utilising the assessed loss in order to avoid liability of the payment of tax, Trollip J remarked, about the section while referring to companies,:

> "[I]t was intended to apply where income was diverted from another person to a company in order to avoid liability for tax on the part of the person .... '[I]ncome' ... received by or ... accrued to a company .... is wide enough to include income produced by its own activities in contradistinction to income diverted to it. [On the other hand] avoiding liability for tax 'on the part of .... another person' ... shows that not only diverted income, but income produced by the company's own activities can fall within the ambit of the section if its other requirements are fulfilled".

All requirements must be satisfied before the commissioner can seek to invoke the section. There should be a pre-existing stream of income divertable to the company sought to be acquired and, with the assessed loss for the presumption of tax avoidance

[114] 31 SATC 48

to be inferred. It must be borne in mind that by disallowing an assessed loss, Revenue is effectively adding back tax deductions to which the taxpayer as previously entitled.[115]

The onus is on the taxpayer is to prove, on a balance of probability, that his sole or main purpose in the agreement or change in shareholding was not to make use of the assessed loss. Presumably where a purchaser is convinced he's not going to benefit from the assessed loss, tax avoidance cannot be said to be his main purpose. If a sound financial reason can be advanced and it can be shown that that the existence of the assessed loss was merely incidental to the main purpose of the transaction, the Commissioner's hands are tied. The Act cannot be invoked[116]. This was the case in ITC 1388[117] where the objective of utilising the assessed loss was to diminish the amount of tax payable. This was subordinate to the main purpose, that is, acquisition of shares efficiently and effectively. This idea of utilising assessed losses was stretched in, ITC 1123[118], to apply where a company earned income after a change in shareholding from activities it had not undertaken before. What of a company that enters into a transaction seeking to utilise its assessed loss faster than it would have had the transaction not been entered into? Can it be said to have entered into the same to avoid liability? After all it would not have any liability in any case in that case. The taxpayer can produce, as evidence to the court, Minutes of Meetings held before the acquisition or change in shareholding. What about instances where the taxpayer has paid more, than they are actually worth, for purchase of shares, in the assessed-loss company? According to Eddie Broomberg [119], a seasoned tax Commentator, such persons ought not object or appeal against the Commissioner's decision when he invokes the provisions of section 103(2). It is only wise to do so if he can show that the extra payment was not intended to pay for the tax benefit of the assessed loss.

In practice however[120], Inland Revenue does not enforce the requirement that income must to be derived from such trading. An intention to derive the same is

[115] 1987 26 Income Tax Reporter 119 at 120
[116] This proposition finds support in ITC 989 25 SATC 122; ITC 1123 31 SATC 48; ITC 1347 44 SATC 33. See 31 SATC 48.
[117] 46 SATC 126
[118] 1969 Taxpayer 208
[119] in Tax Strategy 2nd Edition (1983) 217
[120] According to Divaris C and Stein ML, *Silke on South African Income Tax*, 11 ed (1989) para 8.127 at 2-339 as quoted in Income Tax Reporter (1991) 30 47 at 49

enough. An aggrieved taxpayer could object and appeal against the Commissioner's decision provided for under subsection (4). It is quite noteworthy that under 103(2) the commissioner ought to be simply 'satisfied' with the 'the transaction.....' Meanwhile subsection (4) requires him to prove that 'the transaction ...' The former subsection sets an outright subjective test, while in the latter the pendulum appears to swing towards the objective domain. Proof of a particular fact normally incorporates some objective element(s). This begs to the question, which is the proper test for the commissioner to apply?

It is quite interesting to ask weather the Commissioner may attack an assessed loss scheme of tax avoidance under section 103(1), or the same is the exclusive domain of section subsection (2). According to Silke he can, in appropriate circumstances[121]. With all due respect I think he is incorrect in his observation. If this was the Legislature's intention nothing would have been easier than to say so. Alternatively, why have two provisions in the Act having the same sting? Finally section 103 (2), of the ITA, in itself sufficiently provides for the commissioners remedy upon satisfaction that an agreement affecting any company or it's change of shareholding was solely to utilise as assessed loss or balance thereof and hence avoid liability for any tax, duty or levy on income.

According to de Koker,[122] in practice, where the section is applied by the Commissioner, Inland Revenue raises two assessments on the company. One will exclude the diverted income and show the assessed loss as increased or diminished by the operations of the year excluding those associated with the diverted income, while the other will show the diverted income on which the company will have to pay tax. The section talks of "such" income not all or any income, hence Revenue's practice hereunder is accordingly correct. This was the case in *Conshu (Pty) Ltd v CIR*[123] where the Commissioner issued two revised assessments in relation to 1986 year of assessment. One was a "reduced" and the other "additional" assessment to deal with the so-called "tainted" income.

In this Chapter the main issue of discussion was the concept of Assessed Losses, or balance thereof, and attempts to utilise the same as a conduit to reduce a

[121] Silke on South African Income Tax para 19.17 at 19-38 and 19-39

[122] Koker de A *silke on south african Income Tax* vol. 3 (1998), Butterworths: Durban 19-39

[123] 1994 (4) SA 603 at p 607

person's liability for tax. The discussion has been achieved vide an examination of the relationship between sections 20 and 103(2) both of the ITA. The commissioner's powers are simply to disallow the proposed set-off of any assessed loss or balance thereof against such income. The onus falls on the taxpayer to rebut the presumption that the agreement in question or change in shareholding or members interest, was not entered into solely or mainly to reduce, avoid or postpone the payment of any tax, duty or levy on income.

CLOSING REMARKS

For the South African government to be able to meet its expenditure on facilities in the field of health, housing, water, education and infrastructure their citizens must contribute to the government pot. This involuntary contribution is in the form of taxation. The Income Tax Act 28 of 1997 legitimise this collection. There are two ways in which taxpayers can respond to this Act: one, comply with it or in the alternative refuse to do so. Section 103(1) of the ITA hits at schemes or operations designed to avoid payment of any tax or duty levied on income. Hereunder, as previously discussed, the commissioner must fulfil three main prerequisites. In the exercise of the powers the commissioner must have regard that the underlying intention is to prevent or diminish the intended tax avoidance scheme or operation. The onus is on the taxpayer to discharge the presumption that the transaction was entered into or carried out with the sole purpose of avoiding or postponing liability or reducing any amount of such liability.

Subsection (2) on the other hand targets company agreements or change in the members interest entered into solely or mainly to utilise any assessed loss, or balance thereof, incurred by the company to reduce or avoid liability for the payment of any tax, duty or levy on income. To rebut this presumption a taxpayer has to prove, on a balance of probability, that the sole or main purpose of his acts as not to avoid tax or postpone or reduce the amount thereof.

As aforementioned taxpayers are not obliged to pay the maximum tax. There is freedom to plan one's affairs to avoid this payment. They may choose to rearrange their affairs while taking advantage of the ITA's loopholes. In the alternative, according to Clegg[124], "terminate his income earning source and recreate a new one in such a manner that the income so earned is subjected to a lesser tax than it's predecessor". Only when their actions do not effectively terminate the steam of income, and upon fulfilment of the other requirements, will the commissioner have *standi* to invoke section 103.

[124] op cit p 230

The solution to tax avoidance does not lie with the taxpayer but the lawmaker. Parliament should possess skilled man power capable of detecting problems n the la and remedying them swiftly. This is while recognising that taxpayers will always exercise their freedom of choice and seek to rearrange their affairs while taking advantage of the Acts provision to pay the least amount of tax.

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